S. HRG. 98-1130

TAX TREATMENT OF PROPERTY LEASED BY A TAX EXEMPT ENTITY TO CERTAIN CORRECTIONAL FACILITIES

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

S. 2933

SEPTEMBER 14, 1984

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TAX TREATMENT OF PROPERTY LEASED BY A TAX EXEMPT ENTITY TO CERTAIN CORRECTIONAL FACILITIES

FRIDAY, SEPTEMBER 14, 1984

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 10:31 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood and Symms.

[The press release announcing the hearing, a statement from Senator Bob Dole, and a description of S. 2933 by the Joint Committee on Taxation follow:]

[Press Release]

FINANCE SUBCOMMITTEES SET JOINT HEARING ON S. 2429, TO BE FOLLOWED BY CONSIDERATION OF S. 2933

Senator Bob Packwood, Chairman of the Subcommittee on Taxation and Debt Management, and Senator John C. Danforth, Chairman of the Subcommittee on International Trade of the Committee on Finance, announced today that the Subcommittees would hold a joint hearing on S. 2429, a bill introduced by Senators Packwood and Hatfield. S. 2429 would amend the Tariff Schedules of the United States to increase the duty on certain shelled filberts.

Immediately following the joint hearing, the Subcommittee on Taxation and Debt Management will hear testimony on S. 2933, a bill introduced by Senator D'Amato. S. 2933 would provide that the restrictions imposed by the Deficit Reduction Act of 1984 with respect to property leased by a tax-exempt entity would generally not apply to certain correctional facilities leased by State and local governments.

The hearing will be held on Friday, September 14, 1984, at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

STATEMENT OF SENATOR DOLE

PRISON CONSTRUCTION PRIVATIZATION ACT, SEPTEMBER 14, 1984

I am pleased that Chairman Packwood has scheduled this hearing on S. 2933, a bill that would amend the Government leasing portion of the Deficit Reduction Act of 1984 to exempt certain correctional facilities.

The state of prisons in our country today is an important national concern. Many are overcrowded and provide deplorable living conditions. A number of States are under court order to alleviate the overcrowding with respect to some or all of the correctional facilities within their jurisdictions. Some States have even been forced to release inmates early because of the deplorable conditions in certain of the overcrowded prisons. S. 2933 would attempt to address this pressing problem by permitting the use of private funds as well as Federal Government subsidies to finance the

construction and rehabilitation of prison facilities through use of the sale-leaseback technique.

I will be interested in hearing from the witnesses today regarding whether the sale-leaseback financing technique is the most appropriate way to address this important problem. For example, is the sale-leaseback method, which deflects an indeterminate amount of the Federal tax subsidy to private investors, the most efficient way to provide the Government service? If the Tax Code is an appropriate vehicle for improving prison conditions, should the tax system encourage State and local governments to forgo control over assets which relate directly to their governmental functions? Should the focus of the bill be more appropriately limited to providing incentives for new construction of prison facilities, as opposed to rehabilitation of existing facilities? Lastly, how should Congress draw the line between providing tax incentives for prison construction on the one hand, and providing special treatment for other important governmental projects such as inner city developments, infrastructure needs, convention centers, and medical buildings and hospitals?

I commend Senator D'Amato for his efforts in bringing this issue to the Senate and look forward to the testimony we will hear today.

DESCRIPTION OF S. 2933 RELATING TO LEASING OF QUALIFIED CORRECTIONAL FACILITIES TO STATE AND LOCAL GOVERNMENTAL UNITS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON

SEPTEMBER 14, 1984

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing, to be held on September 14, 1984, on S. 2933 (introduced by Senator D'Amato). In general, S. 2933 would exempt certain correctional facilities from the tax-exempt entity leasing provisions of the Deficit Reduction Act of 1984 (P.L. 98-369) (the Act).

The first part of this document is a summary of S. 2933. The second part is a more detailed description of the bill, including present law, issues, explanation of provisions, and effective date.

I. SUMMARY

Present law imposes restrictions on cost recovery, or depreciation, deductions with respect to certain property, including certain correctional facilities, leased by a taxable entity to a State or political subdivision thereof (or any agency or instrumentality of either). Similarly, present law disallows rehabilitation tax credits with respect to such facilities which would otherwise be available.

The bill would generally remove those restrictions for certain correctional facilities. In addition, the bill would provide that any agreement with respect to such facilities which is characterized by all parties to the agreement as a lease is to be treated as a lease for all purposes of the Internal Revenue Code.

The bill would apply to certain correctional facilities placed in service after December 31, 1984.

II. DESCRIPTION OF THE BILL

A. Present Law

Overview

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code. Rather, they are embodied in a series of court cases and in revenue rulings and revenue procedures issued by the IRS. Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who is entitled to the tax benefits associated with ownership of the property. Thus, in a purported lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that it has sufficient economic indicia of ownership.

In general, tax benefits associated with ownership of tangible property include depreciation or accelerated cost recovery deductions and investment tax credits. Generally, ACRS or other depreciation deductions and investment credits are allowed only for property used for a business or income-producing purpose. The accelerated cost recovery system generally permits taxpayers to depreciate qualifying property on an accelerated basis over a relatively short period of time. For most property, the ACRS recovery period is shorter than the actual useful economic life of the property. For example, as a result of the Act, real property may generally be depreciated on an accelerated basis over an 18-year period. Investment credits permit taxpayers to reduce their tax liability by a percentage of their investment in eligible property. Eligible property generally includes certain depreciable personal property. Additional investment credits are available for certain improvements to buildings at least 30 years old (the rehabilitation tax credit).

As a general rule, States and political subdivisions thereof (and agencies and instrumentalities of either) are not entitled to depreciation deductions or investment credits for property owned by them. In addition, as a result of the Act, generally depreciation deductions are slowed down for property, including correctional facilities, leased to such a governmental unit. Moreover, no investment credit is allowed for certain property leased to (but not owned by) such a governmental unit (the nontaxable use restriction).

The ownership issue

The determination of the Federal income tax ownership of property requires a case-by-case analysis of all the facts and circumstances. Although the determination of who is the tax owner of property is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership has sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership. The lessor must be the person who suffers, or benefits, from fluctuations in the value of the property. Thus, lease treatment is denied, and the nominal lessee is treated as the owner, if the nominal lessee has an option to obtain title to the property at the end of the nominal lease for a price that is small in relation to the value of the property at the time the option is exercisable (as determined at the time the parties entered into the agreement) or which is relatively small when compared with the total payments to be made under the nominal lease.

Where the nominal lessor's residual value in the property is small, the nominal lessor is viewed as having transferred full ownership of the property for the rental payments. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the nominal lessor is viewed as having transferred full ownership because of the likelihood that the nominal lessee will exercise the option. Furthermore, if the nominal lessor has a contractual right to require the nominal lessee to purchase the property at the end of the nominal lease (a put), the transaction could be denied lease treatment because the put eliminates the nominal lessor's risk of loss in value of the residual interest and the risk that there will be no market for the property at the end of the nominal lease.

To give taxpayers guidance in structuring certain leveraged leases (e.g., leases in which the property is financed by a nonrecourse loan from a third party), the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS generally will issue an advance letter ruling that the transaction is a lease and that the nominal lessor is the owner for Federal income tax purposes.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property.

2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). That rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the exercise date.

3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.

4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any loan to the lessor.

5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit and have a positive cash flow from the transaction independent of tax benefits.

6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for leveraged lease treatment.

In the Economic Recovery Tax Act of 1981, the Congress enacted rules substantially liberalizing, in many cases, the principles to be applied in determining whether a nominal lessor of property would be treated as the tax owner of the property. Under those rules (the safe-harbor lease rules), a nominal lessor could be treated as the tax owner of the property, and entitled to the tax benefits resulting from such characterization, even though under general tax principles and the guidelines it would not have been treated as the tax owner. However, the safe-harbor lease rules did not apply if the nominal lessee was a governmental unit.

Largely because of a popular perception that the safe-harbor lease rules opened the tax system to manipulation, they were generally repealed by the Tax Equity and Fiscal Responsibility Tax Act of 1982.

Depreciation

Generally, property eligible for depreciation may be depreciated on an accelerated basis over a recovery period which is shorter than the economic useful life of the property. For example, real property may generally be written off on an accelerated basis over as little as 18 years, and depreciable personal property may generally be written off on an accelerated basis over 3 years or 5 years.

However, as a result of the Act, accelerated methods of depreciation with respect to certain depreciable property leased to a governmental unit (tax-exempt use property) are not allowed and the applicable recovery period is extended. In the case of tax-exempt use real property, depreciation deductions generally must be taken on a straight-line basis over the greater of (1) 40 years, or (2) 125 percent of the lease term. In the case of tax-exempt use personal property, depreciation deductions generally must be taken over the greater of (1) the property's midpoint life under the Asset Depreciation Range system, or (2) 125 percent of the lease term.

Under the Act, real property leased to a governmental unit is treated as tax-exempt use property to the extent of disqualified uses, but only if disqualified uses of the property exceed 35 percent of all uses of the property. In general, a disqualified use includes a lease of property to a governmental unit if (1) the governmental unit participates in financing the property through the issuance of tax-exempt obligations, (2) the lease contains a fixed or determinable price purchase or sale option or the equivalent thereof, (3) the lease has a term exceeding 20 years, or (4) the lease occurs after a sale by, lease from, or other transfer by the governmental unit of the property and the property was used by the governmental unit prior to the transfer. With certain exceptions, any personal proper-

ty leased to a governmental unit is treated as tax-exempt use property.

Investment tax credit

Generally, property that is used by a governmental unit is ineligible for the investment tax credit.

To determine whether property is subject to this nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of the property. Under the nontaxable use restriction, the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit. In addition, property leased to a governmental unit is generally subject to the nontaxable use restriction. As a result of the Act, the rehabilitation tax credit is unavailable for all tax-exempt use real property.

B. Issues

As discussed above, the Deficit Reduction Act of 1984 slowed down allowable depreciation deductions for certain depreciable property leased to governmental units. In addition, the Act generally made the rehabilitation tax credit unavailable for tax-exempt use real property. Prior to the Act, when a governmental unit used property under lease arrangements, they paid reduced rents that reflected a pass-through from the owner of the property of some or all of the benefits of the investment incentives provided by the rules regarding depreciation and investment credits. Governmental units thereby benefitted from investment incentives for which they did not qualify directly and effectively gained the advantage of taking income tax deductions and credits while having no corresponding liability to pay any tax on income from the property. In this way, investment incentives that were intended to reduce the tax on taxable entities were turned into unintended benefits for governmental units. Concerned that those benefits were equivalent to an open-ended spending program, operated within the tax system, that increased the Federal deficit and encouraged tax-exempt entities to dispose of the assets they owned and forego control over the assets they use, the Congress reacted by enacting the tax-exempt entity leasing rules in the Act. Those rules enable governmental units to lease property on terms no more beneficial to them than would be the case if they were purchasing the property.

On the other hand, in many States in this country there is a great need for new correctional facilities. In addition, in at least some States, substantial funds for new correctional facilities may not be readily available. Relaxing with respect to correctional facilities restrictions on depreciation deductions and rehabilitation tax credits imposed by the Act (and by general tax principles regarding who is the tax owner of the property) would tend to reduce the cost of those facilities to governmental units, by providing a Federal income tax subsidy, and thereby tend to increase the stock of correctional facilities' capacity.

C. Explanation of Provisions

In general, the bill would repeal the restrictions imposed by the Act on the depreciation of qualified correctional facilities leased by a tax-paying entity to a State or political subdivision (or an agency or instrumentality of either). As a result, the tax-paying entity would generally be able to depreciate the facility on an accelerated basis over as little as 18 years (to the extent the leased facility is real property) or as little as 3 or 5 years (to the extent the leased facility is personal property).

In addition, the bill, for all purposes of the Internal Revenue Code, would treat an agreement with respect to a qualified correctional facility as a lease, the nominal lessor as the tax owner of the facility, and the nominal lessee as lessee of the facility if all parties to the agreement characterize it as a lease. This rule would apply notwithstanding the fact that, under general Federal income tax principles, the nominal lessee would be treated as tax owner of the facility. Under this rule, for example, the nominal lessor would be entitled to rapid depreciation deductions even though, had the Act not been enacted, it would not have been treated as tax owner of the facility and therefore would have been entitled to no depreciation deductions with respect to the facility. This rule would in effect make the now-repeated safe-harbor lease rules available in the case of certain correctional facilities nominally leased to a State or political subdivision thereof (or an agency or instrumentality of either).

The bill generally would also have the effect of allowing a rehabilitation tax credit to the nominal lessor with respect to the facility if, prior to the Act, a rehabilitation tax credit would have been available to it. That credit would also be available to the nominal lessor even though under general tax principles, the nominal lessor would not be treated as owning the facility. However, the bill would generally have no effect on the availability of other investment tax credits.

Under the bill, a qualified correctional facility means any property devoted primarily for use as a prison, jail, or other detention facility (and any related facility) which is leased by a State or political subdivision (or agency or instrumentality of either) within 90 days (1) after it is originally placed in service by the nominal lessor or nominal lessee, or (2) of the completion of a substantial rehabilitation by the nominal lessor or nominal lessee.

D. Effective Date

The bill would apply to property placed in service after December 31, 1984.

Senator PACKWOOD. Now we will move on to our next bill, S. 2933. And we have first the Honorable Al D'Amato.

Good morning, Al.

Senator D'AMATO. Good morning, Bob.

Senator PACKWOOD. Your daughter is getting married tomorrow, right?

Senator D'AMATO. That's correct.

Senator PACKWOOD. Well, Steve and I won't keep you here more than 2 or 3 hours with questions on this.

Senator D'AMATO. I think you would have an angry daughter down here after me. I just spoke to her, and she said, "Daddy, make it short." [Laughter.]

Senator PACKWOOD. I might say before you start to other New Yorkers that may be in the audience, I don't think I know a single Senator in the Senate that is as tenacious in fighting for the interest of his state is Al D'Amato. Tenacious to the extent that he wins a great many of them because he simply overwhelms us and we give in to his tenacity. You are very, very good at adequately representing the interest of your State.

Senator D'AMATO. Mr. Chairman, let me thank you for the very flattering remarks.

Senator SYMMS. Mr. Chairman, I agree with you, but after all he comes from a State that has got about 11 million people. They ought to be able to send a good one down here. [Laughter.]

Senator D'AMATO. You are only off by 6 million. We have 17 million. [Laughter.]

Eleven million would be manageable.

Senator SYMMS. You look at how few they had to select from from Oregon and Idaho, and you will see.

Senator D'AMATO. Well, they could be more selective.

STATEMENT OF HON. ALFONSE M. D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. Mr. Chairman, let me first thank you for arranging this hearing on such short notice understanding the demands on your time. And I don't intend to belabor this, but I do believe that with respect to S. 2933, the Prison Construction Privatization Act, we have a unique opportunity to deal with a crisis of monumental proportions facing our State and local prison systems.

I'm going to summarize my testimony and ask that it be included in the record in its entirety.

But if I might be permitted to just touch on some of the problems. Today more than 30 States in the United States are under court order directing the release of prisoners because of overcrowding. That's how terrible the overcrowding problem has become. And community after community is beset with this problem. The need for new prison construction on the State and local level is immense. By checking with local officials, you will find that it is a situation that exists in most States.

The problem that the local officials are faced with is the inordinate cost for prison construction. The bond issues, in some cases, must get two-thirds voter approval. The fact is voters have the kind

of attitude that we are tired of building Taj Mahals for prisoners. The public wants to stick them anywhere and just get them off the street.

And then you have the courts who are coming down on the other side saying, "Wait a minute. The overcrowding situations are such that this is cruel and unusual punishment." And whether or not we agree or disagree, what we see taking place is 20,000 prisoners a year being released from prisons throughout this Nation not because they have been rehabilitated or they served out their full sentence, but rather because they have hit arbitrary limits that require their being set free.

In New York City last year, we had the tragic case of a Federal judge ordering the release of 613 prisoners. Again, not screened out because they were ready to return to society, but simply because a judge determined that there were 613 prisoners too many in this one city facility, Rikers Island Facility, that holds about 10,000 prisoners. And they were set loose on the streets.

Within a short period of time, more than 35 percent had been rearrested for the most incredible crimes—rape, homicide, burglaries, robberies, et cetera.

This is a situation which is intolerable. What does S. 2933 do? It would exempt State and local prison and jail construction from the sale/leaseback restrictions of the recently passed tax bill. This would allow private capital to flow into the construction of prison space. This would reduce the cost of building prisons by 25%.

The Congressional Budget Office estimates that about 50,000 cells would be built—over a 5-year period because of S. 2933.

When we talk about a reduction in cost of 25 percent to local taxpayers, I think we can then begin to help local officials and State officials who are dealing with this problem. Crime comes down when we take dangerous criminals off the streets and put them where they should be. I'm not talking about the white collar crime. We are talking about violent criminals.

And this is a nationwide concern. Crime statistics begin to indicate—and I think there is a direct correlationship—that with the increasing prison population, crime levels come down. This bill will help further this process.

I understand the Finance Committee's desire to see to it that we don't get into some of the sale/leaseback abuses that previously existed. If there are recommendations by the committee that would assure that my bill does not lead to abuses, then I would be very willing to entertain those suggestions.

I would point out that my bill would prohibit a sale/leaseback of an existing structure that has not been rehabilitated. If we give accelerated depreciation to housing then I feel that prison construction is equally as important from a policy viewpoint.

We are not talking about, again, a gimmick whereby we pass on tax benefits to those who have not really created something. We are talking about encouraging private money being used to make available more prison space.

So, Mr. Chairman, I thank you for giving us this hearing. We have several local officials who can give examples of the kinds of serious problems that they face in prison overcrowding. And I would hope that we could gain your strong support and the support of this committee for S. 2933.

Senator PACKWOOD. This is not unlike the bill that Senator Durenberger had some time ago. As I recall, he once had a similar proposal for prisons and I thought it was a good idea at the time.

Senator D'AMATO. I would hope that maybe we could galvanize support for such legislation. We are not talking about great sums of money. I think CBO made an estimate. They estimated my bill would cost over a 5-year period of time roughly $65 million a year. This would be money well spent to help local government remedy a national problem. But the Federal Government would only share the burden. Local government would still absorb significant costs.

You will hear some testimony from a local supervisor about a county of about 150,000 people which is faced with the construction of a prison that will cost about $16 million. That's a lot of money. It's a county of 150,000 people. And the estimate is that they could reduce this cost by about $4 million with my bill. Now their voters will probably never approve the construction of that prison facility. They need a two-thirds approval. And so my bill will help local officials to, No. 1, cut costs by about 25 percent; No. 2, there's a good likelihood that they won't have to go through the cumbersome bond procedure; No. 3, there is no doubt in my mind that the private sector can construct quicker, faster, cheaper in and of its own than that in which the——

Senator SYMMS. Who is going to operate the prison? The private sector?

Senator D'AMATO. No. The concept—we don't cover that, but it is envisioned in most cases—and we will have some experts who.will testify to it that it will be built by private contractors, specifications being put out by Government, and then leased, sale and leaseback, to the local government.

Senator SYMMS. So you still have the Government running the prison?

Senator D'AMATO. Yes.

Senator SYMMS. How much does it cost per year to incarcerate a prisoner in New York, for example?

Senator D'AMATO. Well, at State prisons it will run as high as $15,000.00.

Senator SYMMS. Why not just put it out to bid and let some guy go run a private business?

Senator D'AMATO. You would never get that passed, I don't think, in any State legislature because you do have the requirements.

Senator SYMMS. You could have the requirements. You could have a State——

Senator D'AMATO. Well, in terms of the prison guards, et cetera, their qualifications, their training, their responsibility.

Senator SYMMS. Look at the money it would save Government if they would just hire out the operation of the prisons and let somebody build a jail and lock them up.

Senator D'AMATO. There are those who are indicating that we should look to the private sector.

Senator SYMMS. You would have State pensions or Federal civil service pensions and all those benefits you have to worry about with retirement programs. Just contract the whole thing out. Put it out for bid. I bet they would do it for half of that.

Senator D'AMATO. Well, I have some serious concerns about the private sector running prisons.

Senator SYMMS. I happen to be for privatization. I appreciate what you are trying to do.

Senator D'AMATO. But you are going one step further.

Senator SYMMS. But my concern is you are talking about two tax breaks here, if I understand it right.

Senator D'AMATO. Right.

Senator SYMMS. You are going to sell revenue bonds and then lease it back? Both?

Senator D'AMATO. Well, they can do that and you have accelerated depreciation that is utilized in a sale/leaseback. My bill would also not require repurchase of the facility at fair market value. This would enable the sale/leaseback to make economic sense.

That gives you about a 20- to 25-percent reduction in interest costs compared to traditional financing.

Senator SYMMS. But you are still going to end up with the high operational costs of the bureaucracy of operating the business.

Senator D'AMATO. My bill does not address operation.

Senator SYMMS. What I am saying is that if it's a big cost on Government, with the State, Federal, local, on incarcerating criminal elements, and as a cost to society, why not just say we have got to have a place to incarcerate 500 prisoners and we will put it up for bid, and you have to meet certain standards of human fairness and so forth for those prisoners. And just put them in and lock them up and let the private people be bonded and take the responsibility to keep them locked up.

Senator D'AMATO. Well, indeed, certain states have begun to privatize their prisons—California, Colorado, and Texas have undertaken that kind of experiment. Not in terms of the whole system.

Senator SYMMS. Then you would really be privatizing without a Government subsidy handed through the back door.

Senator D'AMATO. Let me simply suggest to you that I think this is a step in the right direction. If we are going to give accelerated depreciation, which we do to private developers for the building of housing or sewage treatment plants, then certainly I would suggest that prison construction is a national priority. That we are encouraging the construction of something that is desperately needed. And we are doing it in a way that is going to cut costs to Government. And I think that this cuts some of the costs for local government. The Federal Government will not foot the whole bill. Yes, they are going to give a meaningful contribution. But you know the Federal Government has a responsibility that flows to the State and local governments, even in the area of local crime enforcement.

Let me suggest to you why I feel very strongly about this. A significant portion of the crime that is created comes about as a result of drugs. Most crimes are drug related. And a significant portion of the drugs that create this problem come in and are produced outside of the United States of America. And it gets a little bit ridiculous to simply say, well, this is strictly a local enforcement problem. We can't walk away from the problem.

Now we have begun as a nation—and I would say in the past 4 years—to rebuild our drug enforcement agencies. We strengthened

the Customs agency. To begin to bring about better border interdiction. Begin to cooperate with foreign governments in seeing to it that the drug production and distribution networks are broken. Great progress has been made. But more work must be done.

Our Government has not devoted the resources, the manpower, and have not prioritized, I believe, our battle against drugs and the crime related problems that come about directly and indirectly from drugs.

So I think my bill is a way to take a step forward. It's not the answer, Senator Symms, to all of the problems. It's not the answer to all of the high costs in building prisons. Let me tell a story. I sent out a mailer, about 4½ million pieces, on prison construction, on the problem of overcrowding of people. We asked a series of questions, such as should we build more prisons. You can't believe the response. People say, "Kill them. Put them on an island. We don't care."

I understand people's frustrations. They don't want to pay the cost of new prisons. They understand the costs associated with the construction and the operation of these facilities. And they hear $15,000 per annum and they say, "My gosh, first I'm victimized by a criminal and then I have got to pay these inordinate costs to house them, to feed them, et cetera, and provide security."

My bill at least, is a step in the right direction with respect to privatization of construction. Possibly it may lead to a further privatization in the area that you have suggested. But it is a first step. If we can't get to at least build these prisons using private sector their privatization will never occur. Especially if sale/leasebacks are so much cheaper than traditional financing.

And in some of these cases, local municipalities simply don't have the credit ratings. They have got to pay terribly high interest rates by using bonds. My bill would help those districts. So this is another factor that reduces tremendously.

Let me say that I thank you for the hearing. I hope we can enlist your support. And if there are any suggestions with respect to the improvement of this legislation—this is a Senator who does not say, oh, it's got to go my way. I would ask the committee for any recommendations, any help, in improving this legislation. I think my bill is a forward step to meet a difficult problem.

Senator PACKWOOD. Al, thank you very much. Would you care to join us while we hear the panel?

Senator D'AMATO. I would be most delighted, most privileged.

Senator PACKWOOD. Come up and join us.

Senator D'AMATO. Thank you, Mr. Chairman.

[The prepared statement of Senator D'Amato follows:]

ALFONSE M. D'AMATO TESTIMONY ON S. 2933,

THE PRISON CONSTRUCTION PRIVATIZATION ACT

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISCUSS BOTH OUR DESPERATE NEED FOR NEW PRISON SPACE AND MY LEGISLATION, S. 2933, THE PRISON CONSTRUCTION PRIVATIZATION ACT.

FIRST I WOULD LIKE TO DESCRIBE THE CURRENT STATE OF OVERCROWDING IN OUR NATION'S PRISONS AND JAILS. SOME MAY SAY, "WHO CARES ABOUT OVERCROWDING? LET THE CRIMINALS SUFFER!!" THERE IS NO LOVE LOST BETWEEN THIS SENATOR AND COVICTED FELONS. HOWEVER, JUDGES HAVE FORCED CITIZENS AND POLICYMAKERS TO CONSIDER THIS PROBLEM.

IN 1983 ALONE, 21,420 INDIVIDUALS WERE PREMATURELY RELEASED FROM PRISON AND PUT BACK ONTO OUR STREETS SIMPLY BECAUSE OF OVERCROWDING. TENS OF THOUSANDS MORE WERE RELEASED FROM LOCAL JAILS, ALSO PREMATURELY.

LAST NOVEMBER, A FEDERAL JUDGE ORDERED 613 PRISONERS RELEASED FROM THE NEW YORK CITY JAIL AT RIKER'S ISLAND. SINCE THEN TWO-THIRDS OF THESE INDIVIDUALS HAVE EITHER COMMITTED NEW CRIMES OR HAVE SKIPPED BAIL. THE RESULT IS THAT THE GOOD WORK OF LOCAL LAW ENFORCEMENT OFFICERS GOES FOR NAUGHT. MORE IMPORTANTLY, OUR CITIZENS ARE FURTHER TERRORIZED.

PRISON OVERCROWDING IS A NATIONAL PROBLEM. THIS IS NOT A PROBLEM ONLY FOR NEW YORK. TODAY, 30 STATES HAVE THEIR ENTIRE PRISON SYSTEMS, OR INDIVIDUAL JAILS WITHIN THEIR SYSTEMS, UNDER COURT ORDER TO RELIEVE OVERCROWDING. MANY OF THESE STATES ARE REPRESENTED BY MEMBERS OF THIS COMMITTEE.

SO IT IS NOT A MATTER OF WANTING TO MAKE THE LIVES OF PRISONERS MORE COMFORTABLE. THE ISSUE IS THIS: HOW DO WE KEEP HARDENED CRIMINALS OFF OUR STREETS?

THE ATTORNEY GENERAL JUST REPORTED A RECORD 7% DROP IN THE SERIOUS CRIME RATE FOR 1983. HE ATTRIBUTED THE DECLINE, IN PART, TO PUTTING MORE CRIMINALS BEHIND BARS. BY

INCREASING THE NUMBER OF PRISON INMATES FROM 230,000 IN 1974, TO 440,000 TODAY, WE HAVE BEGUN TO CUT INTO CRIME. THIS PROCESS MUST BE CONTINUED. CRIME CANNOT BE FOUGHT WITHOUT ADEQUATE PRISON SPACE.

FOR MANY JUDGES, HOWEVER, THE ISSUE IS A MATTER OF CIVIL RIGHTS. THAT IS, A GROSSLY OVERCROWDED PRISON OR JAIL REPRESENTS CRUEL AND UNUSUAL PUNISHMENT. INMATES ARE PUT BACK ON THE STREETS, NOT BECAUSE THEY HAVE BEEN REHABILITATED, NOT BECAUSE THEY HAVE COMPLETED THEIR SENTENCES, NOT BECAUSE THEY ARE NO LONGER A THREAT TO SOCIETY, BUT MERELY BECAUSE THERE IS INSUFFICIENT SPACE TO HOUSE THEM!

MR. CHAIRMAN, I DO NOT WANT TO GET INTO A DEBATE OVER WHAT IS CRUEL AND UNUSUAL PUNISHMENT OR WHETHER JUDGES ARE ACTING IN THE BEST INTERESTS OF THE PUBLIC. BUT I DO WANT TO FORCE DEBATE ON A PROBLEM THAT MANY WOULD RATHER SKIRT: THE ROLE OF THE FEDERAL GOVERNMENT IN RELIEVING PRISON OVERCROWDING.

SHOULD THE FEDERAL GOVERNMENT BECOME INVOLVED IN RELIEVING PRISON OVERCROWDING? ABSOLUTELY YES! EVERY RECENT ADMINISTRATION, REPUBLICAN AND DEMOCRATIC, HAS RECOGNIZED THE IMPORTANCE OF FIGHTING CRIME. HAVING A PLACE TO PUT CONVICTED CRIMINALS IS A PREREQUISITE TO MAKING A DENT IN CRIME.

THERE IS A FEDERAL RESPONSIBILITY BECAUSE MOST CRIME IS RELATED TO TRAFFICKING IN, AND THE USE OF, DRUGS THAT THE FEDERAL GOVERNMENT HAS THE DUTY TO KEEP OUT OF THIS COUNTRY.

THERE IS A FEDERAL RESPONSIBILITY BECAUSE OVERCROWDING IS ALSO DUE IN LARGE PART TO THE FEDERAL GOVERNMENT'S FAILURE TO KEEP OUT THOUSANDS OF CRIMINALS RELEASED FROM CASTRO'S PRISONS, AND ILLEGAL ALIEN FELONS FROM OTHER NATIONS.

SHOULD THE FEDERAL GOVERNMENT SHOULDER THE <u>WHOLE</u> BURDEN IN BUILDING OR REHABILITATING STATE AND LOCAL PRISONS AND JAILS? ABSOLUTELY NOT!

AS I STATED BEFORE, THE PROBLEM IS NATIONAL IN SCOPE. WITH A $170 BILLION FEDERAL BUDGET DEFICIT, A SYSTEM OF COST SHARING BETWEEN THE VARIOUS LEVELS OF GOVERNMENT MUST BE DEVISED. BUT WE CANNOT JUST PASS THE BUCK TO STATE AND LOCAL GOVERNMENTS.

I BELIEVE THAT THE USE OF SALE/LEASEBACKS BY GOVERNMENT ENTITIES IS A VERY SOUND APPROACH. IT WOULD ENTAIL THE EXTENSION OF TAX INCENTIVES BY THE FEDERAL GOVERNMENT TO PRIVATE CORPORATIONS THROUGH STATE AND LOCAL GOVERNMENT ENTITIES. IN EXCHANGE FOR THIS, PRIVATE ENTITIES WOULD LEASE PRISONS, JAILS, AND DETENTION CENTERS BACK TO STATE AND LOCAL GOVERNMENTS AT A DISCOUNT. IN THIS WAY, THE FEDERAL GOVERNMENT WOULD BEAR SOME, BUT NOT ALL, AND NOT EVEN MOST, OF THE COSTS FOR PROVIDING NEW PRISON BEDS.

S. 2933 WOULD DEEM THE SALE/LEASEBACK OF A PRISON, JAIL, OR DETENTION CENTER BETWEEN A PRIVATE ENTITY AND A STATE OR LOCAL GOVERNMENT TO BE A "SERVICE CONTRACT" FOR TAX PURPOSES. THIS WOULD ALLOW THE PRIVATE SECTOR TO BECOME

MORE INVOLVED IN THE CONSTRUCTION OF PRISONS, JAILS, AND DETENTION CENTERS.

WHY IS THIS IMPORTANT? THE PROCESS OF PRIVATE SECTOR CONSTRUCTION OF PRISONS HAS ALREADY BEGUN. BASED ON EXPERIENCE, PRIVATE CORPORATIONS CAN BUILD PRISONS FOR 75% OF WHAT IT WOULD COST STATE AND LOCAL GOVERNMENT. THESE ARE SAVINGS THAT ACCRUE TO STATE AND LOCAL TAXPAYERS.

PRIVATE SECTOR INVOLVEMENT IN PRISON CONSTRUCTION MUST BE FURTHER ENCOURAGED. MY BILL WOULD EXPEDITE THIS PROCESS. THIS WOULD BE DONE BY EXEMPTING STATE AND LOCAL PRISON, JAIL, AND DETENTION CENTER CONSTRUCTION AND REHABILITATION FROM THE SALE/LEASEBACK RESTRICTIONS OF THE RECENTLY PASSED TAX BILL.

ACCORDING TO THE CONGRESSIONAL BUDGET OFFICE, S. 2933 WOULD RESULT IN ROUGHLY $1.5 BILLION WORTH OF NEW PRISON SPACE, OR OVER 50,000 NEW PRISON BEDS, BEING BUILT OVER THE NEXT 5 YEARS.

CBO ALSO ESTIMATES THAT MY BILL WOULD COST THE FEDERAL GOVERNMENT AN AVERAGE OF ONLY $65.5 MILLION PER YEAR IN LOST REVENUES. BUT, FOR THIS SMALL PRICE, THE MUNICIPAL FINANCE OFFICERS ASSOCIATION HAS ESTIMATED THAT THE USE OF SALE/LEASEBACKS WOULD SAVE AN AVERAGE OF 22%, AS COMPARED TO THE USE OF GENERAL OBLIGATION BONDS. TO LIMIT THE REVENUE LOSS TO THE FEDERAL GOVERNMENT, AND TO ALLOW A PROPER REVIEW OF THE SUCCESS OF THIS PROGRAM, MY BILL WOULD SUNSET IN 1989.

THE USE OF SALE/LEASEBACKS WOULD NOT BE PREFERABLE FOR ALL LOCAL ENTITIES. THOSE WITH THE HIGHEST CREDIT RATINGS WOULD PROBABLY NOT TAKE ADVANTAGE OF SALE/LEASEBACKS. HOWEVER, THOSE GOVERNMENT ENTITIES WITH WEAK OR NON-EXISTENT CREDIT RATINGS COULD USE THE SALE/LEASEBACK TECHNIQUE.

CURRENTLY, LOCAL ENTITIES WITH WEAK CREDIT RATINGS MUST EITHER USE TAX REVENUES OR FOREGO PRISON CONSTRUCTION. IN BOTH CASES, THE PUBLIC PAYS A GREAT PRICE.

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MR. CHAIRMAN, S. 2933 WOULD UNLEASH PRIVATE CAPITAL TO BUILD MUCH NEEDED PRISON SPACE. THE BILL WOULD ALLOW STATE AND LOCAL GOVERNMENTS TO USE FEDERAL TAX INCENTIVES TO BUILD 50,000 NEW BEDS. THIS CAN SAVE STATE AND LOCAL TAXPAYERS UP TO 22% FROM THE COST OF TRADITIONAL FINANCING.

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO TESTIFY TODAY. I WOULD ENJOY ANSWERING ANY QUESTIONS YOU MIGHT HAVE.

Senator SYMMS. Thank you very much.

Senator PACKWOOD. We will hear from a panel of Sterling Johnson, special assistant district attorney, Office of Prosecution, New York, NY; John Gillespie, correctional facilities, finance specialist for Shearson Lehman/American Express; A.C. Dake, chairman, law and finance, Saratoga County Board of Supervisors; and Nina McGuire, national sales director, Corrections Systems Division, Control Data.

Mr. Johnson, why don't you go ahead?

STATEMENT OF STERLING JOHNSON, JR., SPECIAL ASSISTANT DISTRICT ATTORNEY, OFFICE OF PROSECUTION, SPECIAL NARCOTICS COURTS, NEW YORK, NY

Mr. JOHNSON. Mr. Chairman, I would like to thank you for the opportunity for appearing at this session. I have spoken to Senator D'Amato. I have reviewed his bill, and I wholeheartedly support and endorse the bill.

I have been a professional prosecutor and have been in law enforcement all of my professional career. At the current time, I am the special narcotics prosecutor for the city of New York.

This bill would help me in my efforts and other people in law enforcement greatly. As Senator D'Amato pointed out, one of the problems that we face not only in New York City but in this Nation is a problem of drugs. The problem is of such a magnitude that it's estimated that it's $100 billion a year. Much of it coming in through the ports of New York City. And when you talk about drugs, you are also taking about crime.

There was a study conducted in Baltimore, I think in 1980-81, where they studied 243 addicts over an 11 year period. And they discovered that these 243 addicts committed something like a half a million crimes. That is 2,000 crimes per addict per year.

Recently—and I will elaborate a little later on—we had an experiment or project in Manhattan called "Operation Pressure Point." And we directed law enforcement efforts toward a specific geographic area. It was a targeted area. And something like 5,000, 6,000 people were arrested over a short period of time.

And after they examined the crime statistics for burglary, larceny and robbery, there was a dramatic decrease in the amount of these particular crimes not only in the targeted area, but also in the surrounding or contiguous areas. So there is a definite relationship between drugs and crime.

I have heard and read reports of how crime has decreased. This might be true in some areas, but it has not been indicated to be the fact as far as drugs are concerned. There are a series of articles being published at the current time—I think the last one today—in the New York Times, and they speak of the drug problem and the increased use of drugs and drug abuse in this nation. I think the article stated, and I think observedly so, that there are between 500,000 and 600,000 heroin addicts. They said that 10 percent of this population, of the U.S. Government population, has used cocaine. And that's over 20 million people. One million used cocaine regularly. And approximately one-quarter of the U.S. population uses marijuana. So drugs and crime are directly related. And if some crime is being decreased in this country, it is not the drug crimes.

Thank you.

Senator PACKWOOD. Thank you very much.

[The prepared written statement of Mr. Johnson follows:]

STATEMENT OF JOHN W. GILLESPIE, CORRECTIONAL FACILITIES FINANCE SPECIALIST, PUBLIC FINANCE DIVISION, SHEARSON LEHMAN/AMERICAN EXPRESS, INC., NEW YORK, NY

Senator PACKWOOD. Mr. Gillespie.

Mr. GILLESPIE. Mr. Chairman and members of the committee, I would like to thank you for this opportunity to appear before the committee. And I would like to thank Senator D'Amato for introducing the legislation which is addressing the serious prison overcrowding crisis.

I have a prepared statement which I would like to ask permission to have inserted in the record, and would like to summarize it, if I may.

My name is John W. Gillespie, and I'm the correctional facilities finance specialist in the Public Finance Investment Banking Division of Shearson Lehman/American Express. The firm has served as managing investment banker or financial advisor for over $350 million in correctional facilities financings during the past 3 years. I am currently working with numerous State and local governments throughout the country to assist in solving the increasingly critical problem of financing new or renovated prisons, jails, and detention facilities at an affordable cost to taxpayers.

New construction or renovation of existing facilities can provide a partial solution to our growing prison problem. However, such programs are often precluded by the high cost of financing, by the failure of municipal bond referenda in some communities, or by the

seemingly more pressing funding requirements of other public works projects.

Enactment of Senate bill 2933 could greatly assist in relieving the correctional facilities crisis through financing alternatives which allow lower costs and faster implementation of prison construction programs. The legislation would create an exception from the definition of tax exempt use property for qualified correctional facilities. The bill would thus create financial incentives for the private sector to assist State and local governments in new prison construction and renovation projects.

Specifically, the legislation would once again allow certain investment tax credits, rehabilitation tax credits, more advantageous lease terms and specified purchase options that were restricted under current changes in the Tax Code. The changes would make private sector financing, construction, ownership and in some cases, operation of correctional facilities an attractive option for both municipalities and private investors. The incentives would thus provide three major advantages to State and local governments which are seeking to expand, replace or renovate their correctional facilities. First, the incentives would attract private equity capital and bring this source of funds to bear on behalf of State and local governments. Such funding will be particularly useful in situations where a government is unable to finance the project itself because of economic or legal constraints of its issuance of additional debt.

The second major advantage is that private sector construction projects can often be completed faster and less expensively than construction in the private sector, as Senator D'Amato has pointed out. One recent example is the new U.S. Immigration and Naturalization Service detention facility in Houston, TX, which began operating this spring. The facility was designed, financed and constructed by the Corrections Corporation of America in approximately one-third the time and at less than one-half the cost of comparable facilities. Such cost savings could be passed on to the Government in the form of lower annual lease payments.

The third major advantage of the proposed legislation is that the savings attributable to the tax credits, depreciation rules and any rehabilitation credit could also be passed on to the municipality in the form of reduced lease payments.

Correctional facilities have traditionally been financed by State and local governments through the use of general obligation bonds. It has become increasingly difficult for many jurisdictions throughout the United States to provide such funding in recent years because of debt limitations, referendum requirements, administrative delays or other priorities for a community's debt capacity.

In cases where general obligation funding has not been possible or where leasing transactions have been able to show a cost savings, State and local governments have begun to explore private ownership of these facilities. Such options have been particularly advantageous for facilities that can be financed using tax exempt industrial development bonds. However, current law limits the use of such financing to facilities with costs totaling under $10 million, thus not permitting many large State and county correctional facilities construction projects to use these savings.

An additional problem is that even if complying with this $10 million limit, correctional facilities currently fall under the new State volume cap limitations and the $40 million overall limitation for a particular beneficiary of industrial development bonds. Therefore, privately financed correctional institutions have to compete with more popular projects for selection under a State cap and corporations of an efficient scale will quickly run up against the $40 million overall limit.

I would, therefore, urge the committee to consider putting correctional facilities in the same category as airports, convention facilities, docks, wharves, and mass transit facilities and exempt them from the volume of $40 million overall restrictions as well as the $10 million limitation on industrial revenue bonds for this type of facility.

Such a change would be especially useful in making the rehabilitation of larger facilities feasible under sale/lease back financings, which are usually dependent on IDB financing.

The economic advantages to a State or local government of using the provisions embodied in S. 2933 would vary depending on the assumed interest rates for private sector financing, the potential construction cost advantages, the percentage of the facility eligible for the investment tax credit, the categories of accelerated depreciation, the availability of industrial development bond financing and a number of other factors.

Using a range of assumptions that would be typical for the cases that we have seen in a new correctional facility financing—this would include a conservatively estimated 15-percent cost savings on construction—Senate bill 2933 could permit savings of from 20 to 30 percent versus general obligation financing if any industrial development bond was available to support the privatization. The rules applicable under the legislation could save from 10 to 20 percent if an industrial development bond was not available and the privatization was financed using taxable debt.

In most instances, a municipality would use the sale/leaseback financing technique which would be permissible under S. 2933 for a situation involving a substantial rehabilitation of an existing facility. Such transactions can be extremely complex and the economic benefits would vary depending upon a number of factors involved in determining the tax advantages, the rehabilitation credits, whether the facility is eligible for a historical rehabilitation credit, the value of the ground lease to the municipality, and a number of other factors.

The potential advantages and the resulting incentives for the private sector to assist in this area would be greatly enhanced by amending the previously cited restrictions on the availability of IDB's for such projects. In most cases, it should be possible to show economic benefits for sale/leaseback rehabilitations under this bill, and thus create a good argument for using this technique.

State and local governments are clearly in need of emergency assistance to meet the correctional facilities' overcrowding crisis. The availability of some restored tax advantages and their sunset in 4 years as provided in S. 2933 could provide both the economic and timing incentives to solve this crisis now before it is too late.

Thank you.

Senator PACKWOOD. Thank you.
[The prepared written statement of Mr. Gillespie follows:]

TESTIMONY BEFORE THE U.S. SENATE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE ON S. 2903 CONCERNING PRISON CONSTRUCTION PRIVATIZATION

September 14, 1984

John W. Gillespie
Correctional Facilities Finance Specialist
Public Finance Division
Shearson Lehman/American Express Inc.
Two World Trade Center - 105th Floor
New York, New York 10048

My name is John W. Gillespie and I am the correctional facilities finance specialist in the public finance investment banking division of Shearson Lehman/American Express Inc. The firm has served as managing investment banker or financial advisor for over $350 million in correctional facilities financings during the past three years. I am currently working with numerous state and local governments throughout the country to assist in solving the increasingly critical problem of financing new or renovated prisons, jails and detention facilities at an affordable cost to taxpayers.

The need for secure and constitutionally adequate correctional facilities has rapidly emerged as one of the largest and most frustrating problems for state and local governments. Policymakers are being squeezed by the public's demand for more incarceration and the taxpayers' reluctance to pay for additional prisons and jails. At the same time, the courts are responding to prisoners' demands for less crowded facilities while the cost of correctional facilities construction continues to rise at well above the rate of inflation.

Currently, 33 states and over 400 of the nation's counties are operating correctional facilities under court orders requiring reductions in overcrowding or the relief of unconstitutional conditions. According to the Criminal Justice Institute, prison populations are projected to increase 12% in 1984 and an additional 11% in 1985. This rapid growth is expected to continue at least through the remainder of the 1980's.

As a direct result of overcrowding and the obsolescence of correctional facilities, we have recently witnessed an increase in escapes, physical harm to both inmates and correctional officers, the court-ordered early release of inmates, and an accelerated deterioration within our prisons and jails. New construction or renovation of existing facilities can provide a partial solution to our growing prison problem. However, such programs are often precluded by the high costs of financing, by the failure of municipal bond referenda, or by the seemingly more pressing funding requirements of other public works projects.

Enactment of Senate Bill 2903 could greatly assist in relieving the correctional facilities crisis through financing alternatives which allow lower costs and faster implementation of prison construction programs. The legislation would create an exception from the definition of tax exempt use property for qualified correctional facilities. The bill would thus create financial incentives for the private sector to assist state and local governments in new prison construction and renovation projects.

Specifically, the legislation would once again allow certain investment tax credits, rehabilitation tax credits, more advantageous lease terms and specified purchase options that were restricted under recent changes in the Tax Code. The changes would make private sector financing, construction, ownership and in some cases, operation of correctional facilities an attractive option for both municipalities and private investors. The incentives would provide three major advantages to state and local governments which are seeking to expand, replace or renovate their correctional facilities. First, the incentives would attract private equity capital and bring this source of funds to bear on behalf of state and local

governments. Such funding will be particularly useful in situations where a government is unable to finance the project itself because of economic or legal constraints on its issuance of additional debt. The second major advantage is that private sector construction projects can often be completed faster and less expensively than construction in the public sector. One recent example is the new U.S. Immigration and Naturalization Service detention facility in Houston, Texas which began operating this spring. The facility was designed, financed and constructed by the Corrections Corporation of America in approximately one-third the time and at less than one-half the cost of comparable facilities. Such cost savings can be passed on to the government in the form of lower annual lease payments. The third major advantage of the proposed legislation is that the savings attributable to investment tax credits, more advantageous depreciation rules and any rehabilitation credit could also be passed on to the municipality in the form of reduced lease payments.

Correctional facilities have traditionally been financed by state and local governments through the use of general obligation bonds. It has become increasingly difficult for many jurisdictions to provide such funding in recent years because of debt limitations, referendum requirements, administrative delays or other priorities for a community's debt capacity. In cases where general obligation funding has not been possible or where leasing transactions have been able to show a cost savings, state and local governments have begun to explore private ownership of public facilities. Such options have been particularly advantageous for facilities that can be financed using tax-exempt industrial development bonds. However, current law limits the use of such financing to facilities with costs totaling under $10 million, thus not permiting many large state and county correctional facilities construction projects to use these savings.

An additional problem is that, even if complying with the $10 million limit, correctional facilities fall under the new state volume cap limitations and the $40 million overall limitation for a particular beneficiary of industrial development bonds. Therefore, privately financed correctional institutions have to compete with more popular projects for selection under a state cap and corporations of an efficient scale will quickly run up against the $40 million overall limit. I would urge that the Committee consider putting correctional facilities in the same category as airports, convention facilities, docks, wharfs and mass-transit facilities and exempt them from the volume and $40 million restrictions as well as from the $10 million limit. Such a change would be especially useful in making the rehabilitation of larger facilities feasible under sale/leaseback financings, which are usually dependent on IDB financing.

The economic advantages to a state or local government of using the provisions embodied in S. 2903 would vary depending on the assumed interest rates for private sector financing, the potential construction cost advantages, the percentage of the facility eligible for the investment tax credit, the categories of accelerated depreciation, the availablity of industrial development bond financing and other factors. Using a range of assumptions that would be typical for a new correctional facility financing (including a 15 percent cost saving on construction), S. 2903 could permit savings of from 20 to 30 percent versus general obligation financing if an industrial development bond was available to support the privatization. The rules applicable under the legislation could save from 10 to 20 percent if an industrial development bond was not available and the privatization was financed using taxable debt.

In most instances a municipality would use the sale/leaseback financing technique which would be permissible under S. 2903 for a situation involving a substantial rehabilitation of an existing facility. Such transactions can be extremely complex and the economic benefits would vary depending on such factors as the percentage of the rehabilitation cost that would be eligible for the tax advantages, whether the facility is over 30 years old or eligible for an historic rehabilitation credit, the value of the ground lease to the municipality, the value of the building prior to the rehabilitation as reflected in the sale price, the cost of the repurchase, if exercised, the availability of an industrial development bond for the privatization, among others. The potential advantages and the resulting incentives for the private sector to assist in this area would be greatly enhanced by amending the previously cited restrictions on the availability of IDB's for such projects. In most cases it should be possible to show economic benefits for sale/leaseback rehabilitations under the S. 2903 rules and thus create a good argument for using this technique.

State and local governments are clearly in need of emergency assistance to meet the correctional facilities overcrowding crisis. The availability of some restored tax advantages and their sunset in four years as provided in S. 2903 could provide the economic and timing incentives to solve this crisis now before it is too late.

STATEMENT OF MRS. A.C. DAKE, CHAIRMAN, LAW AND FINANCE, SARATOGA COUNTY BOARD OF SUPERVISORS, SARATOGA, NY

Senator PACKWOOD. Ms. Dake.

Mrs. DAKE. Good morning. My name is A.C. Dake, and I'm a local, elected official in Saratoga County. I chair the Law and Finance Committee of the Saratoga County Board of Supervisors.

I am very pleased to be able to address this issue, which has been raised by Senator D'Amato, because it addresses the problem which is presently facing us in Saratoga County.

Saratoga County has a population of 153,759, which is up from 121,764 in 1970. We have a jail. It was constructed in 1967. And at that time, it met all the State and Federal mandates and we thought it was adequate for the projected needs of the future. Within 8 years, our jail was out of compliance and we are now in the position of boarding out up to 35 prisoners each day at a price of somewhere between $50 and $75 a day, depending on what other county can take them. You add that to the wear and tear on the sheriff's vehicles who transport these prisoners and the cost of the transporting deputies' time, and what I consider to be the injustice of local prisoners who are, by definition, not convicted of horrible crimes having to serve their time sometimes halfway across the State, far from their families and their attorneys, and you have a serious problem.

We are dealing with a portion of the problem by using an assortment of alternatives to incarceration which are serving to reduce the number of prisoner days in our jail. Among these alternatives are a very excellent release on recognizance program, pretrial diversion, intensive supervision program, weekend sentencing, double celling, and, of course, probation in general. We have reduced our prisoner lead significantly through these programs.

When I talk about double celling, that's something we have done for just a little while. We petitioned the State to allow us to do it, and they let us do it for a 90-day trial period. It worked very well in Saratoga County. The prisoners liked it. Of course, we didn't have to board out the 16 prisoners involved, and saved us that money. However, the State, for whatever reason, decided not to allow us to do it any more.

We felt it was capricious. At one point we won a lawsuit and were allowed to double cell again, increasing our capacity once again by 16. And then the State turned off the faucet on the 16 people. Our sheriff, took one of the State-ready prisoners that we are compelled to house if the State doesn't have room for them, because New York State has a serious problem, and he told the deputy: "You take that prisoner down to the State prison. If they don't accept him, just chain him to the fence," which he did.

We got a little national attention, a little State attention, and the State is now taking our State-ready prisoners a little more quickly.

Our problem, in other words, is not strictly a local problem in terms of overcrowding. We sometimes have to house State-ready prisoners for as long as a week. They pay us $15. It costs us $50 to $75 a day to farm out our own prisoners to other facilities.

We are addressing the long-term problem by attempting to construct a new jail in our county. We have before us next Thursday a proposal for a new 160-cell jail, which will cost $10.5. We heard earlier in the year proposals for private financing with a leaseback, which would have saved our county property taxpayers a considerable sum. Both of these proposals were determined by our county attorney to be now illegal due to the new Federal restrictions.

I predict that our elected officials will vote to defeat this bond issue because they are understandably reluctant to add the annual cost of conventional bonding, which is going to be in the neighborhood of $1 million a year for a 15-year period, to the levy, which last year was $11 million. That is a very significant figure, of course, in local financing.

Private financing with a leaseback would, by the proposals made to us earlier this year, have cost first of all a fixed amount each year, which was in one case only $510,000 for a 20-year period, which is a total savings of $5 million to the property taxpayers. Bonding, in effect, depending upon the timeframe you are talking about, adds 50 to 100 percent to the cost of the construction project. It doesn't add to the construction cost. It adds to the interest cost.

If you read this carefully, you will notice that I'm talking about the 15-year proposal that is actually on the table of our board of supervisors, and a 20-year proposal that was made earlier. Those are two actual proposals. The figure for a 20-year bond issue was $18 million, as opposed to the total $12 million it would have been for the privately financed jail with a leaseback. So you are talking about a potential interest savings of $6 million to local taxpayers.

The two things I have mentioned are not identical because they are real proposals, not hypothetical proposals, and they never actually existed side by side. But they were both presented to us this year. Had it been legal to go with private financing, we would have done it.

The cost of financing for this jail, which is already expensive at $10.5 million, is so great that I do predict that it will not be passed by our county board of supervisors, and we are going to be right back with our overcrowding problem, with a budget item in our budget for 1984 of a half million dollars for farming out of prisoners.

This is no joke. We are in trouble with our jail capacity. We need a new jail, and our taxpayers need a break. I would like to see that interest break. And I think Senator D'Amato's proposal is an excellent one, and I urge you to give it very positive consideration.

Thank you.

Senator PACKWOOD. Thank you.

[The prepared written statement of Mrs. Dake follows:]

Board of Supervisors
SARATOGA COUNTY
MRS. A.C. DAKE
City of Saratoga Springs
14 Longwood Drive
Saratoga Springs, N.Y. 12866

Testimony before the Senate Finance Committee
September 14, 1984
9:30 A.M.
Subject: Prison Construction Privatization Act S.2933
at the request of Senator Alfonse D'Amato

Good morning. My name is A.C. Dake, and I am a local elected official in Saratoga County in Upstate New York. I chair the Law and Finance Committee of the Saratoga County Board of Supervisors.

I am pleased to have the opportunity to address the issue raised by Senator D'Amato's proposed Prison Construction Privatization Act since it addresses directly a problem presently facing Saratoga County.

Saratoga County has a population of 153,759, up from 121,764 in 1970. We have a jail, constructed in 1967, which at the time met all the state and federal mandates and was adequate for the projected needs. Within eight years, our jail was out of compliance and we are now in the position of "boarding out" up to 35 prisoners each day at a price of between $50 and $75 per day, depending on what other county can take them. Add this expense to the wear and tear on the sheriff's vehicles transporting these prisoners, the transporting deputies' time, and the injustice of local prisoners, who are by definition not convicted of horrible crimes having to serve their time halfway

across the state in some cases, far from their families and their attorneys, and you have a serious problem.

We are dealing with a portion of the problem by using an assortment of alternatives to incarceration to reduce prisoner days in our jail. Among these alternatives are an excellent Release on Recognizance program, diversion, intensive supervision, weekend sentencing, double-ceiling, and of course probation in general. We have reduced our prisoner load significantly through these programs.

We are addressing the long-term problem by attempting to construct a new jail in our county. We have before us next Thursday a proposal for a new 160 cell jail, which will cost $10, 500,000. We heard proposals for private financing, with a lease back, which would have saved our county property taxpayers a considerable sum. Both of these proposals were determined by our county attorney to be now illegal due to the new restrictions. I predict that our new jail will go down to defeat because our local elected officials are understandably reluctant to add the annual cost of conventional bonding, which is in the neighborhood of $1,000,000 for a 15 year period, to the levy which last year was $11,000,000. Private financing with a lease-back, would, by the proposals made to us earlier this year, have cost, first of all, a fixed amount each year, which was in one case only $510,000 for 20 years, a total saving of $5,000,000 to the property taxpayers. Bonding in effect adds from 50% to 100% to the cost of the construction project.

Gentlemen, this is no joke - we're in trouble with our jail capacity. We need a new jail, and our taxpayers need a break. Senator D'Amato's proposal is a good one.

STATEMENT OF MS. NINA L. McGUIRE, NATIONAL SALES DIRECTOR, CORRECTIONS SYSTEMS DIVISION, CONTROL DATA, WASHINGTON, DC

Senator PACKWOOD. Ms. McGuire.

Ms. MCGUIRE. I'm here to speak in favor of Mr. D'Amato's Senate bill, S. 2933. I am here representing Control Data's Corrections Systems Division. Control Data, for almost 20 years, has been involved with applying its computer technology in new strategies which work toward human problems and look at them as business opportunities.

In about 1972, we began working with a number of correction facilities across the country to develop new products and services which would meet the needs of the corrections industry. And over the years have been working with a number of these facilities. At the present time, we are working with 63 facilities in 20 States.

There is obviously severe and unusual overcrowding in the correctional system, and that's at all levels. A number of States have not only exceeded their official capacity, but many of them are under court mandates to correct their problems. And many of them are having great difficulty both financially and in terms of programs meeting those needs. We certainly have a crisis situation on our hands.

In many of these cases, the public sector is turning to private industry for construction, private financing, program content, and other assistance. One of the priorities of Control Data's Corrections Systems Division has been to look at some of these extreme overcrowding. And in this regard, I would like to take about a minute and tell you about our residential community centers, which are being planned and developed now to provide a significant alternative to present or traditional probation, designed primarily for the property offender. These centers would house 80 to 100 convicted felons. While the emphasis is on providing a secure and safe facility, which is well administered to meet State or county regulations, I might also comment that the residential centers offer much more. One of the primary problems is not only the severe overcrowding but the incredible rates of recidivism, the number of prisoners who leave the prison system and reenter it, either very rapidly as your samples show, or often within 90 days to a year. States by States might vary from about 25 to 50 percent, but significant numbers are repeat offenders.

Within the residential centers we look at assessments, education and training programs, job development programs, and a sheltered workshop, the theory being that as these felons complete their, if you will, debt to serving their sentence, they are also somewhat more educated and somewhat more job ready, and have more of the life coping and job coping skills.

In this case, the first one of these is being developed with private financing. These can be delivered either through direct contract with the State or turnkey facilities financed by the private sector. So I offer this as one example of where our corporation has been moving over the past several years, in a sense, in support of your bill, and in a sense, also in trying hard to take a look at how we might be responsive.

Now as the private and public sectors search for alternative methods to finance, house, and train our Nation's incarcerated population, we feel that it's increasingly important as long as this critical overburdening exists, that those companies willing to work with Government have some ways, and financially viable ways, to do so. We see accelerated depreciation and other tax incentives on property leased to tax-exempt entities as a very important step in this direction.

I was so pleased to hear Senator D'Amato suggest that he would be willing to look at some ways in which the bill might be expanded because I presume that I might have the opportunity to do that.

First, I would suggest that the language of the bill or the committee report be expanded to ensure that the accelerated depreciation and other tax incentives would apply also to diversionary and alternative sentencing facilities, since correctional facilities may be construed a little narrowly to mean only prisons or only prisons and jails. Halfway houses, prerelease centers, or a number of other parts of the correctional system that I would suggest would be important additionally.

Second, I would suggest that the language of the bill or the committee report be expanded to ensure that the accelerated depreciation and/or other tax incentives apply also to facilities where the private sector not only constructs but manages all or a portions of the facility, under contract with the local or State governmental agency.

I comment on this because at the present time many State facilities are subcontracting food services, health services. And in some States, education and vocational training, or a limited number of certain prison industry services. We already have a number of parts of this puzzle happening. I'm not speaking to the security and the administration services, but I would suggest that there might be some tie between the two where it's privately constructed and, in addition, privately managed.

I would also suggest that you look at tax incentives offered by job oriented education and training to inmates. In at least three States, there is no budget for education and training of offenders. It's obvious this reduces their ability even if there was extreme interest when they leave prison to find a job and hold a job.

And, lastly, perhaps it would be useful to look at the accelerated depreciation and other tax incentives to apply for the lease of capital equipment within those facilities, which would be constructed or managed by the private sector.

It's a little bit presumptuous to sit here and offer four major items, but from our experience, we feel that they would be good additions to the bill and perhaps would be with your consideration.

We thank you very much for the opportunity to speak for this important legislation. Obviously Control Data supports it in its current form or in any expansion of it, and we appreciate this time.

Senator PACKWOOD. Your suggestions are not presumptuous at all. In my 15, 16 years of experience, I have discovered that people who have to work with things in the field have infinitely more experience, practical experience, than we do with many things. And the suggestions that they have to offer are quite often very valid.

[The prepared written statement of Ms. McGuire follows:]

Testimony

of

Nina L. McGuire
National Sales Director
Corrections Systems Division
Control Data Corporation

Before the

Subcommittee on Tax and Debt Management

Concerning S. 2933
"Prison Construction Privatization Act of 1984"

September 14, 1984

Washington, D. C.

Senator D'Amato and members of the Senate Subcommittee on Tax and Debt Management.

On behalf of Control Data's Corrections Systems Division, thank you for the opportunity to comment on S. 2933, the Prison Construction Privatization Act, which would amend the Internal Revenue Code of 1954 to provide accelerated depreciation and tax incentives for the private sector to build facilities to house prisoners and lease the facilities to state and local governments.

As background, for almost two decades, Control Data has pursued a business strategy of applying its computer technology, financial and human resources to address society's unmet needs as profitable business opportunities. These needs include

reduction in unemployment, especially for the disadvantaged; more responsive education and training; revitalization of poverty-stricken urban and rural areas; a more viable small business sector; lower cost and more efficient public services.

Since 1972, Control Data has been working with the corrections industry to identify programs, products and services which would be useful in helping to reduce recidivism. At present, the Corrections Systems Division provides programs and services to over 60 correctional facilities in more than 20 states.

There is severe overcrowding in the correctional system. At present, over 40 states exceed their official capacity. In many of these states, the public sector is turning to private industry for construction, private financing, programmatic, and other assistance.

One of our Corrections Systems Division's priorities to reduce recidivism centers on containment facilities which provide a significant alternative to prison or traditional probation. The Residential Community Center is designed to house 80-100 convicted felons. While the emphasis is on providing a secure facility, the Residential Community Centers offer much more: assessment; education and training programs; job search, job and life coping skill development; a sheltered work environment and numerous other programs which better prepare the felon to successfully make the necessary social and economic transition back into the community.

The Residential Community Centers can be delivered either through direct contract with a state or as turn-key facilities financed by the private sector.

Control Data supports S. 2933. As the private and public sectors search for alternative methods to finance, house and train our nation's incarcerated population, it is especially important that those companies willing to work with government to address these problems be provided a financially viable way to do so. Accelerated depreciation and other tax incentives on property leased to tax-exempt entities is an important step in this direction.

However, I would like to suggest that the committee consider expanding the bill in a number of ways:

- The language of the bill should be expanded to ensure that the accelerated depreciation and other tax incentives apply to diversionary and alternative sentencing facilities, since "correctional facilities" as mentioned within the bill may be narrowly construed to mean only prisons.

- The language of the bill should be expanded to ensure that the accelerated depreciation and other tax incentives apply to facilities where the private sector manages the facility, under contract with the governmental agency, as well as the construction of facilities as currently outlined in the bill.

- It is also suggested that tax incentives be offered for job-oriented education and vocational training where the private sector delivers these services in the facilities constructed and/or managed by the private sector.

- Lastly, it is suggested that accelerated depreciation and other tax incentives apply for the lease of capital equipment within those facilities which would be constructed and/or managed by the private sector.

The Control Data Corrections Systems Division appreciates the opportunity to speak in support of this important legislation. A more detailed statement will be submitted to the Committee, and I would ask that it be printed in the record of these hearings.

Thank you.

Senator PACKWOOD. Al.

Senator D'AMATO. Thank you, Mr. Chairman.

I was wondering if possibly Sterling Johnson, who has spent his life in this type of work in New York, might make a comment and tell us how jail overcrowding has affected you efforts in New York City to combat crime.

Mr. JOHNSON. Well, the New York State prison system is at 116 percent capacity. The New York City prison system is 100-plus, 101, 102 percent capacity. As you indicated earlier in your testimony, Senator, that a Federal judge mandated that New York City release 600 and some odd prisoners back out on the street.

There comes a time when a person has been arrested and comes before the bar and bail must be set. And I don't know the ingredients that go into a judge's decision for bail, but many of these individuals are released upon bail. And I think partly because there is no room in prison to house these people.

And we have many instances where a person has been arrested maybe five and six times for drug violations over a period of several months, and he comes back before the court, and he is still going to be released. And in the interim, he is dealing in drugs and he is still committing crimes. And as long as he is committing crimes, he's a menace to society and he's a problem to law enforcement. And he's a problem to myself.

As a result, there are instances where I must plea bargain. Give away a plea that I normally would not give away. In many cases, I would like to try, but I cannot try because there is no room to put him in jail.

Senator D'AMATO. Thank you, Sterling.

I was wondering if you would give to the chairman just one quick indication of the effectiveness of your drug task force and what it did in the Lower East Side? If you would tell hm what the impact was on crime?

Mr. JOHNSON. There was an incident on the Lower East Side where drug dealers were on street corners in New York City by the thousands. No exaggeration. By the thousands. And they were dealing drugs as if they were giving out free money or selling cabbage patch dolls. And on January 19, the police commissioner came into office and he made drug enforcement his top priority. And he sent in uniformed forces. He sent in plain clothes police officers. And they made thousands and thousands of arrests.

Now he targeted certain geographical precincts, the fifth, the seventh and the ninth. And after a 3-month period, we found out that crime in three specific categories had decreased dramatically. Robberies in the targeted area decreased over 51 percent. Burglaries decreased in the targeted areas over 35 percent. And larcenies decreased in the targeted areas over 7 percent.

In the contiguous surrounding precincts, crime also decreased. Robberies, 24 percent; burglaries, 18 percent; and larcenies remained about the same.

So we see that when we get rid of the people who are committing the crimes, people who are doing the drug dealing, crime will decrease.

Senator PACKWOOD. There was an article in the New York Times magazine section 7 or 8 years ago called "Lock Them Up," and other

solutions to crime. It basically verified what you are saying. That you can talk until you are blue in the face about psychological counseling and everything else you are going to do, but in terms of the incidents of the reduction of crime, if you take certain people off the street, the statistics are very clear in what you are saying.

Mr. JOHNSON. And the national statistics will bear this out. They say crime is down, but you will see that incarceration is up. And that is one of the things that the American people have been asking.

Senator PACKWOOD. One of the most disturbing articles I ever read on this subject, though, was at the Library of Congress. It did it based upon some research of other people. That, indeed, you can almost predict who the criminals are going to be from the 16 and the 17 and the 18 years old and the records and what they have been from 12, and 13, and 14 on. And if you really wanted to reduce crime, you wouldn't wait until they were 25 because many of the murderers and rapists, indeed, are much younger than that. That you would lock up people at 16 and 17 who in all likelihood were going to go straight on to a life of hard crime. And that's a tough decision to make, and you are going to make some mistakes when you do that.

Mr. JOHNSON. Well, I agree with you. It is a difficult decision to make, but we in the public sector have to make some of these decisions.

I think one of the good solutions is that if a person has been accused of a crime, that he should have a fair, speedy trial, and speedy is the key word. And if he is convicted, then he has to go to jail and he should go to jail immediately. But when you have situations where a person—some of the cases that I have—who has been arrested six and seven times over a 3-month period for drugs, it's an indication to the public that the system really does not work.

Senator PACKWOOD. Any more, Al?

Senator D'AMATO. Mr. Chairman, I would like to first of all make a public commendation to Sterling Johnson for his incredible law enforcement efforts over a 20-year period of time. It goes back a little more than 20 years. And then to Supervisor Dake, who comes from a beautiful part of our State called Saratoga.

There are those who say, Mr. Chairman, that rehabilitation and alternatives are the answer. That you don't even need any new prison cells. And they will tell you that. They are against every bond issue even if they don't live in the area. And they will come into communities and work for the defeat of bond issues. And Saratoga is a rather enlightened county.

And I am wondering that as chairman of the law enforcement area, as well as the financial area, you did mention that Saratoga indeed has taken on a very ambitious program for alternatives to incarceration. Is that not correct?

Ms. DAKE. Yes. We have put a new emphasis on alternatives to incarceration. I guess every county probably has a probation department, and a lot of that has worked out of that. We are a very fiscally conservative county, and we would like to think that we are as crime free as we can be. But we have been—particularly because of our overcrowding situation, we have been able to keep the people out of jail who might otherwise have gone to jail. And I

mentioned the release on recognizance program. A great many people cannot lay their hands on the cash to make bail. So they do an evaluation of them, and if they are likely to show up for trial, we release them on recognizance. It works out very well. We have saved a lot of jail days with that.

This intensive supervision is reserved for people who would have been sentenced to somewhere between 6 months and 1 year, and these are people for whom the judge has a sentence in mind. And we put them on an intensive probation program where they do not go to jail unless they violate the terms of their probation.

The double celling, I mentioned before. It allows us to house more people. It's a work program where people do work during the day.

Weekend sentences allow people to maintain their families, to support their families, and yet still serve the sentence which is demanded by their crime.

They are supervised. If they commit a crime, they go to straight time.

It has its problems, but it does allow us more flexibility in our jail. And we have, again, put in a dormitory for those weekend prisoners. I certainly wouldn't want to spend time there. There are six or eight bunk beds with two bunks to a bed and a dilapidated looking ping-pong table, and they lock these 12 guys or however many there are up for the weekend. But they do show up. They serve their time and sentence by the judges. And, otherwise, they would have to be put in single cells in a conventional jail format. County jails must have single cells. And this double-celling is a unique thing.

Senator D'AMATO. Yet in spite of all these methods that you have undertaken—I think that's the important thing. I mean here's a county that embarked upon a reasonable alternative method to incarceration and still find themselves plagued with the problem of insufficent prison cells. I think that's the important thing I would like the record to reflect it.

Ms. DAKE. I think what has happened is that we have diverted some of the short-term prisoners and some people who would otherwise have gone to jail. And what we've done is produce a situation where we have longer terms being served so the number of prisoner days is still going up. We would be having a lot more prisoners in total numbers if we weren't using these alternatives.

Senator PACKWOOD. Let me ask you a question, bearing in mind that since I have been in the Senate—16 years now—I have not been on any committees dealing with crime so my knowledge of it more currently in its treatment is not as specific as it was when I served in the Oregon Legislature and had some direct jurisdiction over our prison.

The man who was then the psychiatrist at the Oregon State Prison came and testifed on the budget issue for the prison, and said that given enough money he could take 10 hard-core criminals, all of whom were likely to come back, given enough money and if he could work with them, he could guarantee that probably one of the 10 would not come back. But he said the problem was he didn't know which one. Would that still be an accurate statement

in terms of talking about hard-core criminals and attempted psychiatric rehabilitation?

Ms. DAKE. I'm going to hedge on your question because we, in the county jails, really do not deal with hard-core criminals.

Senator PACKWOOD. Do you know, Mr. Gillespie? Anybody?

[No response.]

Senator PACKWOOD. I don't know.

Senator D'AMATO. Mr. Chairman, at the risk of sounding presumptuous, I have spent quite a bit of time lately touring state facilities and some of our local county facilities. And when you talk to penal experts and those who are right there on the firing line, you realize that it is not just a matter of rehabilitation. Some prisoners are beyond rehabilitation. You just cannot release individuals that are convicted of murder. So these people must be put away in prisons.

Senator PACKWOOD. The thing I admired about this psychiatrist—because we were talking about putting money into this—he said:

> Representative Packwood, if you are prepared to put that much money up for rehabilitation, you can use it a lot better with juveniles. There are better ways to use the same amount of money that you are talking about giving me to try to rehabilitate hard-core criminals.

Senator D'AMATO. In other words, talking about getting into the area of prevention and alternatives for youngsters, particularly in the drug area.

Senator PACKWOOD. Yes.

Senator D'AMATO. You can make an impact in that as through rehabilitation.

Mr. JOHNSON. I spoke to Commissioner Coughlin, and we were discussing the inmate population in New York State prisons. And we agreed or he informed me of what I had already had a feeling about. That approximately 60 percent of the people in the New York State prisons are there with some sort of drug connected background. If it's not an actual drug transaction, it's a crime that is related to drugs. And if you use the generic term "substance abuse," which included alcohol, you are also talking about better than 70 percent. And many of these inmates have more than one conviction and are recidivists. If that answers your question.

Senator PACKWOOD. I have no more questions. I don't know if you do, Al. This is a most informative panel. I have seldom had a group that really cut across the cross section where every single one of you brings a certain unique background in experience to this problem. You have been most helpful.

Thank you very much for coming down.

Al, thank you for staying.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator PACKWOOD. Good luck tomorrow.

Senator D'AMATO. Thank you.

[Whereupon, at 11:26 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

September 28, 1984

STATEMENT FOR THE RECORD OF
RONALD A. PEARLMAN
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
SUBMITTED TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to submit for the record the Treasury Department's views on S. 2933, which would exempt certain correctional facilities leased to State and local governments from the restrictions on depreciation and the rehabilitation tax credit which generally apply to property leased to governments and other tax-exempt entities.

The Treasury Department believes that the special exemption for correctional facilities is unwarranted and opposes the bill.

Background

Leasing Transactions Prior to the Deficit Reduction Act of 1984. Prior to the Deficit Reduction Act of 1984 (the "DRA"), there had been a sharp increase in the volume of leasing transactions between taxable entities, as lessors, and tax-exempt entities, as lessees. Some of the more celebrated transactions included the sale and leaseback of the city hall building in Atlanta and the sale and leaseback by Bennington College of its classrooms and dormitories to its alumni.

The lease transactions that received the most publicity involved the sale by a tax-exempt entity of a depreciable asset that it owned (usually a building) to a taxable investor, followed by a long-term lease of the property back to the tax-exempt entity. As lessee, the tax-exempt entity retained essentially the same right to use the property as it had before the sale and was obligated to make a series of periodic rental payments to the lessor. As the owner of the property, the lessor was entitled to any depreciation or cost recovery deductions and tax credits associated with the property. Those deductions and credits were, in turn, reflected in the rent charged under the lease, and thus indirectly benefitted the tax-exempt lessee. In some cases, the lessor was able to finance its acquisition of the property with tax-exempt industrial development bonds ("IDBs").

A governmental or other tax-exempt entity that owns property directly is not entitled to the tax deductions or credits that are available to taxable owners of property. The sale-leaseback transactions described above were thus an attempt by certain tax-exempt entities to take advantage of tax benefits for which they did not directly qualify. In the DRA, Congress responded to this use of leasing transactions by restricting the tax benefits available for certain property leased to governmental and other tax-exempt entities. The relevant provisions of the DRA are discussed below.

Cost Recovery or Depreciation Deductions. In general, a lessor of property is required to include in its taxable income any rental income received and is entitled to recover its cost of the property through deductions for depreciation or cost recovery deductions under the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act of 1981. Under ACRS, which is generally applicable to property acquired after 1980, cost recovery deductions are allowed on an accelerated basis over 3 or 5 years for most personal property and, as a result of the DRA, over 18 years for depreciable real property. These cost recovery periods are shorter than the economic useful life of the property.

The DRA required cost recovery or depreciation deductions with respect to certain depreciable property leased to a governmental or other tax-exempt entity to be taken using the straight-line method over an extended period. In the case of real property, deductions generally must be taken on a straight-line basis over the greater of 40 years or 125 percent of the lease term. In the case of personal property, deductions generally must be taken over the greater of the property's midpoint life under the Asset Depreciation Range System or 125 percent of the lease term.

Only property which is "tax-exempt use property" is subject to the special slower depreciation rules. Real property is tax-exempt use property to the extent that it is leased to a governmental or other tax-exempt entity in a "disqualified lease," but only if more than 35 percent of the property is subject to such disqualified leases. A lease to a governmental unit is generally a disqualified lease if the governmental unit participates in financing the property through the issuance of tax-free obligations, if the lease contains a fixed-price purchase or sale option, if the lease term exceeds 20 years, or if the lease is part of a sale-leaseback transaction by the governmental unit. With certain exceptions, any personal property leased to a governmental unit is treated as tax-exempt use property.

Rehabilitation Tax Credit. A lessor of property that qualifies for the regular investment credit generally is entitled to a tax credit equal to 10 percent (6 percent in the case of short-lived property) of its investment. Investments in real property are usually not eligible for the investment credit, but a special tax credit is allowed for certain "qualified rehabilitation expenditures." The tax credit for qualified rehabilitation expenditures (which are generally capital expenditures incurred in the rehabilitation of an existing structure) varies from 15 percent to 25 percent of the total expenditures, depending on the age of the rehabilitated structure and whether the structure qualifies as a "certified historic structure."

In general, prior to the DRA, property which was owned by or leased to a tax-exempt organization or governmental unit did not qualify for the investment credit. However, this rule did not apply with respect to the special credit for qualified rehabilitation expenditures. The DRA expanded the categories of tax-exempt entities subject to this nontaxable use restriction, and also provided that the special credit for qualified rehabilitation expenditures is not available for real property which is tax-exempt use property.

The Ownership Issue. Whether an agreement which is in form a lease will be treated as a lease for tax purposes, or instead as a conditional sale or other financing agreement, is a question of fact to be determined from all the surrounding circumstances. The tax status of such an agreement is important because ownership of the property for tax purposes determines the party entitled to claim the cost recovery deductions and investment credits (if any) associated with the property

The principles used in determining who is the owner of property for tax purposes are embodied in a series of court cases, revenue rulings and revenue procedures. Both the courts and the IRS focus on the economic substance of the transaction rather than its form. In general, the owner of property for tax purposes must possess meaningful benefits and burdens of ownership. The owner will generally be the person who suffers or benefits from fluctuations in the value of the property. For example, a nominal lessee may be treated as the owner of property if it has an option to purchase title to the property at the end of the lease term for a price which is small in relation to the value of the property at the time the option is exercisable, or which is small in relation to the total payments required under the lease. Similarly, where the value of property at the end of the lease will be relatively small, the lessor may be viewed as having transferred full ownership of the property to the lessee.

The DRA did not make any changes in the applicable rules for determining who is the owner of property for tax purposes.

S. 2933

S. 2933 would make three important changes in the rules discussed above with respect to certain correctional facilities.

First, in the case of qualified correctional facilities leased by a taxable entity to a State or political subdivision (or an agency or instrumentality of either), the bill would repeal the restrictions imposed by the DRA on depreciation of property leased to tax-exempt entities. As a result, the lessor would generally be able to depreciate the facility on an accelerated basis over as little as 18 years (to the extent the leased facility is recovery property and real property) or as little as 3 or 5 years (to the extent the leased facility is recovery property and personal property).

Second, the bill would repeal, again with respect to qualified correctional facilities, the restrictions imposed by the DRA on the availability of the special tax credit for qualified rehabilitation expenditures on property leased to tax-exempt entities. As a result, the lessor would be able to obtain a tax credit of from 15 to 25 percent of such expenditures.

Third, the bill would provide that if all parties to any agreement with respect to a qualified correctional facility characterize the agreement as a lease, then the agreement will be treated as a lease (and the nominal lessor and lessee will be treated as the tax owner and lessee) for all purpose of the Internal Revenue Code. This rule would apply notwithstanding that under general Federal income tax principles the nominal lessee would be treated as the tax owner of the facility, and notwithstanding that the DRA made no changes in the applicable rules for determining tax ownership. Thus, the nominal lessor would be entitled to rapid depreciation deductions and the credit for qualified rehabilitation expenditures, despite the fact that these benefits would not have been available even under the rules in effect prior to the DRA.

Under the bill, a qualified correctional facility means any property devoted primarily for use as a prison, jail, or other detention facility (and any related facility) which is leased by a State or political subdivision (or agency or instrumentality of either) within 90 days after it is originally placed in service by the lessor or lessee, or within 90 days of the completion of a substantial rehabilitation by the lessor or lessee.

The bill would generally apply to property placed in service after December 31, 1984.

Discussion

The Treasury Department opposes S. 2933 for substantially the same reasons that it supported the restrictions on tax-exempt entity leasing adopted in the DRA. Prior to the DRA, a governmental unit, although a non-taxpayer, had a tax incentive to lease property rather than to own it. Tax benefits not available to the governmental unit for property it owned could be obtained indirectly by leasing the property from a taxable party. A portion of the tax deductions and credits available to the lessor as owner of the property were passed through to the governmental unit in the form of lower rents. In this way, investment incentives designed to reduce tax rates for taxable entities were turned into a Federal subsidy for governmental units. Congress sought in the DRA to eliminate this unwarranted incentive for leasing by tax-exempt entities and to stem the resultant loss in Federal revenue.

S. 2933 would, in effect, use the Federal tax system to subsidize State and local correctional facilities. Whatever the merits of Federal support for state and local correctional facilities, the tax subsidy created by S. 2933 would be contrary to the tax-exempt leasing restrictions just enacted by Congress, and impossible to control. The subsidy would be available to all State and local governments, regardless of any showing of particular need. The scope and amount of the subsidy would effectively be determined not by the Federal government, but by the governmental units and private-sector entities which would engage in the leasing transactions.

We are sympathetic to concerns regarding the adequacy and condition of many State and local correctional facilities. Nevertheless, we do not believe that S. 2933 is an appropriate response to those concerns. If Federal support for state and local correctional facilities is warranted, it should be provided through the appropriations process, not through the Federal tax laws.

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